Insight on Estate Planning

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Considering an ILIT? Now's the time

People often think of life insurance as "tax-free," but that's not entirely true. Life insurance proceeds generally are *income*-tax-free to your beneficiaries, but if you own the policy at your death, the proceeds may be subject to *estate* taxes. One of the best ways to keep life insurance out of your taxable estate is to place the policy in an irrevocable life insurance trust (ILIT).

If you're thinking about setting up an ILIT for an existing policy, consider doing so before the end of the year, particularly if it's a high-cash-value policy.

Why now?

Contributing a life insurance policy to an ILIT constitutes a taxable gift to the trust beneficiaries of the policy's fair market value (which generally approximates its cash value). Making the gift *this* year allows you to take advantage of the record-high gift tax exemption.

The exemption stands at $5.12 million for 2012, but it's scheduled to drop to $1 million next year. And while, as of this writing, it's not yet certain what Congress will do about gift and estate taxes, many believe that the exemption amount has reached its peak.

Keep in mind that future ILIT contributions to cover premium payments will be taxable gifts. You may, however, be able to apply your annual gift tax exclusion (currently, $13,000; $26,000 for married couples splitting gifts) to reduce or eliminate the tax — provided the ILIT is structured appropriately and certain other requirements are met. Alternatively, if you can afford it, you might take advantage of the $5.12 million exemption to "front-load" the ILIT with cash to fund future premium payments.

Giving up ownership

To remove a life insurance policy from your taxable estate, simply transferring the policy to an ILIT isn't enough. You must also relinquish all "incidents of ownership," such as the power to change or add beneficiaries; to assign, surrender or cancel the policy; to borrow against the policy's cash value; or to pledge the policy as security for a loan. If you retain any incidents of ownership, the insurance proceeds will still be included in your estate and may be subject to estate taxes, depending on the size of your estate and your available estate tax exemption.

Also, be aware of the "three-year rule," under which the proceeds are pulled back into your taxable estate if you die within three years after transferring an existing policy to an ILIT. In light of this rule, the safest strategy is to establish the ILIT first and have it acquire an insurance policy on your life. But if you already own a policy, the sooner you transfer it to an ILIT, the greater the chances that you'll successfully remove it from your estate.

Maintaining flexibility

An ILIT offers significant tax benefits, but it also has some significant limitations. As mentioned, after you transfer a policy to the trust, you can no longer change or add beneficiaries; assign, surrender or cancel the policy; or borrow against or withdraw from the policy's cash value. In addition, you're not allowed to alter the trust's terms or act as trustee.

Nevertheless, there are some techniques available to build flexibility into an ILIT. For example, you can design the trust to:

- Adapt to changing circumstances,
- Provide that children or grandchildren born after you establish the trust be automatically added as beneficiaries, and
- Give the trustee the power to remove beneficiaries under certain circumstances (such as removing your daughter-in-law if she divorces your son).

You can also establish conditions for distributing funds from the ILIT. For example, you might instruct the trustee to withhold funds from a beneficiary who drops out of school or develops a substance abuse problem.

Another strategy is to appoint a "trust protector." A trust protector is a sort of super-trustee who has the power to remove the trustee, amend the trust or take other actions to ensure that the ILIT achieves your objectives in light of changing laws or circumstances.

And with careful planning, it's possible to still tap your policy's cash value under certain circumstances. For example, you can design the ILIT so that it permits the trustee to borrow against or withdraw from the policy's cash value and distribute the funds to your spouse or other beneficiaries for their support. (Bear in mind that the cash value in a life insurance policy is accessed through policy loans, which accrue interest at the current rate, and withdrawals. Loans and withdrawals will decrease the cash surrender value and death benefit.)

IRS allows grantor to recover policy from ILIT

Until recently, it was uncertain whether a grantor's power to acquire a life insurance policy from an ILIT by substituting other assets of equivalent value is an "incident of ownership" that causes the proceeds to be included in the grantor's taxable estate.

Late last year, the IRS issued Revenue Ruling 2011-28, providing that the retention of this right in a nonfiduciary capacity isn't, by itself, an incident of ownership. Under the ruling, to avoid estate tax inclusion, the following conditions must be met:

- The grantor must not serve as trustee.
- The trustee must have a fiduciary obligation to ensure that the substituted assets are of equivalent value.
- The substitution power cannot be exercised in a manner that shifts benefits among the ILIT's beneficiaries.

The ruling makes ILITs more attractive by permitting a grantor to build additional flexibility into the trust. For example, the power to substitute assets might allow a grantor to gain access to the policy's cash value by swapping it for illiquid assets of equivalent value. It also makes it possible to cancel an expensive policy that's no longer needed.

Another option is to retain the right to swap the life insurance policy in the trust for other assets of equivalent value. In a recent ruling, the IRS gave its blessing to this technique. (See "IRS allows grantor to recover policy from ILIT" above.)

Creating wealth

Life insurance is a powerful estate planning tool. It creates an instant source of wealth and liquidity to meet your family's financial needs after you're gone. To shield proceeds from estate taxes, consider transferring your policy to an ILIT. And, if possible, complete the transfer this year to minimize gift taxes on the policy's current value.

Intellectual property requires careful estate planning

If your estate includes forms of intellectual property (IP), such as patents and copyrights, it's important to discuss with your estate planning advisor how to address them in your estate plan. Although these intangible assets can have great value, in many ways they're treated differently from other property types.

Copyrights and patents

IP generally falls into one of four categories: 1) patents, 2) copyrights, 3) trademarks and 4) trade secrets. Here we'll focus on only patents and copyrights, creatures of federal law intended to promote scientific and creative endeavors by providing inventors and artists with exclusive rights to exploit the economic benefits of their work for a predetermined time period:

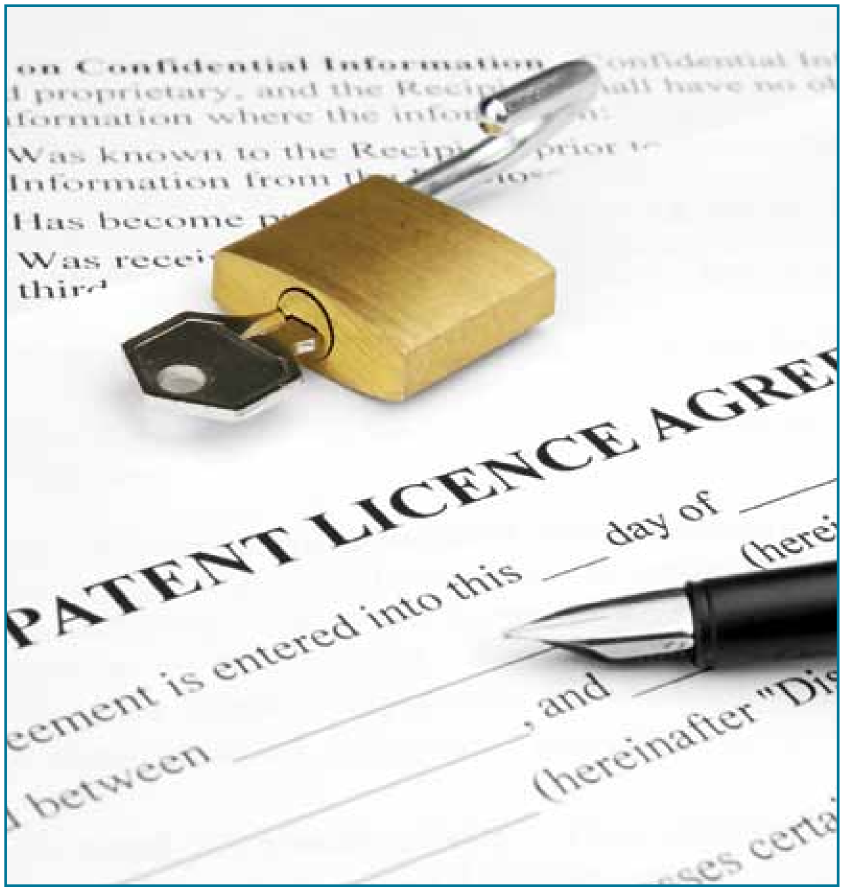
Patents. Patents protect inventions. There are several types of patents; the two most common are utility and design patents. A utility patent may be granted to someone who "invents or discovers any new and useful process, machine, article of manufacture, or compositions of matters, or any new useful improvement thereof." A design patent is available for a "new, original and ornamental design for an article of manufacture." To obtain patent protection, inventions must be novel, "nonobvious" and useful.

There's a common misconception that, when you transfer ownership of the tangible medium on which IP is recorded, you also transfer the IP rights.

Under current law, utility patents protect an invention for 20 years from the patent *application filing* date. Design patents last 14 years from the patent *issue* date. There's a difference between the filing date and issue date. For utility patents, it takes at least a year and a half from date of filing to date of issue.

Copyrights. Copyrights protect the *original* expression of ideas that are fixed in a "tangible medium of expression," typically in the form of written works, music, paintings, sculptures, photographs, sound recordings, films, computer software, architectural works and other creations. Unlike patents, which must be approved by the U.S. Patent and Trademark Office, copyright protection kicks in as soon as a work is fixed in a tangible medium.

For works created in 1978 and later, an author-owned copyright lasts for the author's lifetime plus 70 years. A "work-for-hire" copyright expires 95 years after the first publication date or 120 years after the date the work is created, whichever is earlier. More complex rules apply to works created before 1978.



2 estate planning questions

For estate planning purposes, IP raises two important questions: 1) What's it worth? and 2) How should it be transferred? Valuing IP is a complex process. So it's best to obtain an appraisal from a professional with experience valuing IP.

After you know the IP's value, it's time to decide whether to transfer the IP to family members, colleagues, charities or others through lifetime gifts or through bequests after your death. The gift and estate tax consequences will affect your decision, but also consider your income needs, as well as who is in the best position to monitor your IP rights and take advantage of their benefits.

If you'll continue to depend on the IP for your livelihood, for example, hold on to it at least until you're ready to retire or you no longer need the income. You also might want to retain ownership of the IP if you feel that your children or other transferees lack the desire or wherewithal to exploit its economic potential and monitor and protect it against infringers.

Achieving your objectives

Whichever strategy you choose, it's important to plan the transaction carefully to ensure that your objectives are achieved. There's a common misconception that, when you transfer ownership of the tangible medium on which IP is recorded, you also transfer the IP rights. But IP rights are separate from the work itself and are retained by the creator — even if the work is sold or given away.

Suppose, for example, that you leave a painting, a written manuscript or a film to your child. Unless your estate plan specifically transfers the copyright to your child as well, the copyright may pass as part of your residuary estate and end up in the hands of someone else.

Revise your plan accordingly

If you own patents or copyrights, you probably have great interest in who'll take possession of your work after you're gone. Addressing IP in your estate plan can give you peace of mind that your wishes will be carried out, but the law surrounding such property can be complex. Discuss with your estate planning advisor before taking any action.

Give now, value later

To make the most of the $5.12 million gift tax exemption amount while it's available, many families are making large gifts this year. Such gifts can be a challenge, however, if they consist of illiquid, difficult-to-value assets, such as interests in a closely held business or family limited partnership (FLP). For one thing, they must be supported by a business valuation — a complex, time-consuming process that shouldn't be rushed. For another, because valuation isn't an exact science, there's a risk that the IRS will claim, years later, that a gift was undervalued for tax purposes.

A defined-value gift can address both of these concerns.

Defined-value defined

A defined-value gift is a gift of assets that equal a specific dollar amount, rather than a set number of FLP units or a fixed percentage of a business. It protects you against unexpected taxes down the road in the event it's determined that the FLP or business was undervalued. Although the IRS dislikes defined-value gifts, in recent years they've been upheld by several courts, including the U.S. Tax Court and the U.S. Court of Appeals for the Ninth Circuit.

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For a defined-value gift to work as planned, an attorney must draft the gift language carefully to ensure that it's interpreted as a formula clause rather than a savings clause. A savings clause, which is invalid, essentially reverses a portion of a gift and returns it to the donor in the event it turns out to be taxable. A formula clause, on the other hand, makes a gift of a specified dollar amount that's fixed on the date the gift is made, even though the number of shares needed to produce the gift may be adjusted in the future.

Until earlier this year, all of the cases accepting defined-value gifts involved a "charitable cap." That is, business interests or FLP units were donated to charity to the extent that their value exceeded the amount of the gift.

However, in a recent case — *Wandry v. Commissioner* — the U.S. Tax Court upheld a defined-value gift that lacked this charitable element. In this case, once the value of the entity was determined, the percentage interests in the entity were reallocated among the donor and donees in accordance with the specified dollar amounts.

Planning opportunities

If you wish to make substantial gifts of closely held business interests, FLP units or other difficult-to-value assets before year end, consider defined-value gifts. This strategy allows you to take advantage of the record-high exemption amount — which, as of this writing, is scheduled to expire at the end of the year — without the need for rushed valuations and without the fear of unintended tax consequences should the IRS challenge your gift tax values down the road.

Estate Planning Pitfall

Your family doesn't know where to find your records

If you died today, would your family members know where to locate your will, trusts, life insurance policies and other critical estate planning documents? What about bank and brokerage accounts, IRAs or other qualified retirement plans, mortgages and other loans, real estate documents, tax records, and automobile titles?

The last thing you want is to force your heirs to search for key papers at such a traumatic time. Here are some tips for keeping your important documents secure and accessible:

- Ask your accountant or estate planning attorney to keep your original will and other documents, and provide your family with his or her contact information.
- Store documents in a fireproof lockbox and let your loved ones know where you keep it — and the key or combination.
- Rent a safe deposit box, let your family know where you keep the key and follow the bank's procedures for authorizing them to open it. If you're uncomfortable keeping the key at home, consider leaving it with a trusted advisor.
- To ensure that powers of attorney, living wills or health care directives are readily accessible, consider giving signed "duplicate originals" to the people authorized to make decisions on your behalf. In the case of health care documents, ask your physician to keep duplicate originals with your medical records.
- Make sure your family has access to digital assets, such as online banking and brokerage accounts, electronic bill-paying services and e-mail accounts. If you're uncomfortable keeping a list of user names and passwords, consider an online service that stores this information for you and provides it to your representative when you die or if you become incapacitated.

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